

**THE ABORIGINAL FINANCIAL INSTITUTIONS RISK
MEASUREMENT TOOL
PRESENTATION TO THE OACDC MEMBERS
OACFDC Annual General Meeting April 2008**

BACKGROUND

- Capital erosion in the Aboriginal Financial Institution (AFIs) network had been identified as a significant concern in number of studies undertaken by the government.
- Throughout both developed and under-developed economies, there is recognition of the high costs of providing developmental financing, whether it is micro financing for the poor in under-developed countries, or for start-up costs for SMEs in developed economies.
- In 2004 Aboriginal Business Canada retained Yovhan Burega, a former senior bank executive, to complete a discussion paper to stimulate discussion regarding the establishment of an overall Risk Management Strategy/Framework for the AFIs, which would encourage them to further promote and support their Developmental Lending activities. (a copy of the document is attached). It is interesting to note that Burega advised that **a realistic loan loss rates for Developmental Lending should be closer to 12%. Due to the nature and circumstances of the ACC's markets and impact of the Indian Act, realistic loss rates would be closer to a range of 15%, if Development Lending was increased to its full capacity.**
- The Burega paper identified a number of options to address the high cost of developmental lending, a working group comprised of government, the AFI national association, and AFI managers analysed the options and concluded that an interest rate subsidy (Risk Premium Offset) that connected the risk premium to lending risk and volumes best met the objectives established at the outset of this study:
 - recognize the cost of developmental lending and establishing performance benchmarks appropriate to the unique characteristics and mandate of the AFI network;
 - minimize capital erosion;
 - maximize the placement of existing capital in development lending;
 - support risk measurement and management to acceptable standards and practices;
 - enhance the capacity of existing infrastructure;
 - support self-regulation;
 - attract private capital and partnerships in the long-term.

Elements of the Risk Premium Offset Mechanism

- Premium is determined by the level of risk, low risk or non-developmental loans would not be subsidized, creating the need for a common risk measurement system,
- Audit confirmation that the risk rating of the loan was realistic,
- Adoption of adequate accounting policies that reflect industry standards defined by the Canadian Institute of Chartered Accountants for lenders to ensure that the AFI financial statements more accurately reflected their performance and increased the transparency of revenue and expense recognition,
- Centralize data collection and analysis to facilitate the longer-term objective of attracting private capital.

Development of the Risk Measurement Tool

The working group considered two approaches:

- A blunt instrument, the primary benefit being consistency;
- A tool that would incorporate elements of risk identified in the significant volume of industry literature and adds value to the lending decision (**NOT A DECISION MAKING TOOL, for example CREDIT SCORING SYSTEMS**).
- The AFI managers instructed the working group to develop a tool that would be useful for start-ups and also serve as a resource to train inexperienced lending staff.

The Risk Measurement Tool

Management: Weighting: 30%

1	Very Low	Excellent management team of unquestionable ability, demonstrated by 5 plus years track record of positive earnings.
2	Low	Good management, track record is not yet consistent as demonstrated by fluctuating earnings over the last 3 years.
3	Moderate	Management considered adequate, must rely on outside professional advice to assist in basic business or technical decision-making. Operating results demonstrate fluctuating income. Financial statements prepared under a "Notice to Reader" engagement.
4	High	Management lacks business or technical experience/ability. Their deficiencies although not serious, are causing the business to struggle for its existence. Earnings are weak and below industry norms or no financial statements or on file.
5	Very High	No management experience, lack of technical skills or continuous poor financial performance. Operating results show consistent losses or new business with reasonable projections on file.

Age of Firm Weighting 10%

1	Very Low	The business has been operating for a minimum of ten years.
2	Low	Business operating for 5 to 10 years.
3	Moderate	Business operating for 3 to 5 years.
4	High	Business operating for less than 3 years or a new business but the owner has owned a previous business
5	Very High	New start-up.

Market Weighting 10%

1	Very Low	No competition. Diverse customer base, market stable or growing.
2	Low	Little competition. Diverse customer base, market stable or growing.
3	Moderate	Competition exists; market analysis indicates that market share is available. Market fairly stable but no signs of meaningful growth in the next five years.
4	High	Numerous competitors exist within the community. Market analysis indicates the business will need to capture market share from competitors and or reliance on a small number of customers.

5	Very High	Strong competition exists within immediate community OR Remote Location - Reliance on 1 to 2 key customers.
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Credit History Weighting 10%

1	Very Low	No negative credit information, previous borrower with good track record (no late payments).
2	Low	No negative credit bureau information – previous borrower with some late payments, not over 30 days.
3	Moderate	Credit information reveals some late payments, less than 30 days. Previous borrower some late payments not over 60 days.
4	High	Some late payments, no write-offs, late payments due to disruption in income caused by uncontrollable changes in employment or business.
5	Very High	Credit bureau indicates unpaid collection or judgement, or previous borrower with a history of late payments.

Capacity of the owners (or staying power) Weighting 5%

1	Very Low	Other family income covers all household expenses including household debt and business loan payments.
2	Low	Other family income covers household debt payments but not adequate to cover business loan payments.
3	Moderate	Other family income adequate to service over 75% of household debt payments.
4	High	Other family income covers less than 75% of household debt payments.
5	Very High	No other family income.

Home ownership Weighting 5%

1	Very Low	Owens home less than 25% loan to value ratio.
2	Low	Owens home with loan to value ratio of 25 to 50%.
3	Moderate	Owens home with loan to value ratio of 50 to 75%
4	High	Owens home with loan to value ratio of 75 to 90%.
5	Very High	Does not own home

Financial

Debt leverage: Weighting 5%

1	Very Low	Low level of debt to equity ratio less than 1:1
2	Low	Level of debt lower than sector averages or between 1:1 and 1.5:1
3	Moderate	Level of debt lower than sector averages or between 1:5 and 2:1
4	High	Debt slightly above sector averages debt to equity ratio 2.5:1 and 3.5:1
5	Very High	Debt greatly exceeds sector standards debt equity ratio higher than 3.5:1 or no financial statements provided.

Working capital (including current portion of long-term debt): weighting 5%

1	Very Low	Current ratio greater than 3 to 1.
2	Low	Current ratio between 2 and 3 to 1.
3	Moderate	Current ratio between 1 and 2 to 1.
4	High	Current ratio less than 1 to 1.
5	Very High	Negative working capital, or no financial statements provided.

Repayment ability: weighting 15%

1	Very Low	A 10 year history of profitability and positive cash flow to meet normal operating requirements and scheduled debt payments. Debt service ratio exceeds 2 to 1.
2	Low	Five years of profitability and cash flow demonstrates clear debt servicing ability. Debt service ratio between 1.75 to 2.
3	Moderate	Three years of profitability. Debt service ratio between 1.5 to 1.75.
4	High	Erratic or sporadic earnings with some losses demonstrating a high susceptibility to economic change. The cash flow available to service debt is tight indicating that debt rescheduling is necessary. Debt service ratio between 1 to 1.5 or based strictly on projections.
5	Very High	Earnings have been chronically low or recent significant losses have been recorded. Cash flow is insufficient to service term debt over a reasonable term. OR a new business.

Security: weighting 15%

1	Very Low	Good collateral with first charge. Liquidation of security would preclude the possibility of any loss.
2	Low	Adequate collateral provides 100% coverage although prior charges could inhibit the ability to deal with security.
3	Moderate	While asset quality is satisfactory, collateral if liquidated, would leave a loss not exceeding 25% and/or prior charges could complicate the ability to deal with security.
4	High	Liquidation of our collateral would result in a substantial loss (between 25% to 75%) and/or security values are questionable.
5	Very High	Collateral at liquidation has limited or no value. The possibility of a 75% to 100% loss exists.

Industry Risk: weighting 5%

1	Very Low	Mining and oil and gas extraction. Utilities. Information and cultural industries. Finance and insurance. Real estate and rental and leasing. Management of companies and enterprises. Educational services. Health care and social assistance. Arts entertainment and recreation. Public administration.
2	Low	Agriculture, forestry, fishing and hunting. Wholesale trade. Professional, scientific and technical services. Administrative and support, waste management and remediation services.
3	Moderate	Manufacturing. Transportation and warehousing. Other services (except public administration)
4	High	Accommodation and food.
5	Very High	Construction. Retail trade.

SUMMARY: Risk Analysis and Matrix

Factor	Very Low 1	Low 2	Moderate 3	High 4	Very High 5	Weighting	Score
Management						15	
Age of Firm						10	
Market						10	
Credit History						10	
Capacity of Owners						10	
Financial							
Debt Leverage						5	
Working Capital						5	
Repayment Ability						15	
Security						15	
Industry						5	
						100	

Overall Score

Factor	
Less than 200	Very Low 1
200 to 299	Low 2
300 to 399	Moderate 3
400 to 499	High 4
500	Very High 5

VALIDATION PROCESS

- A draft version of the tool was circulated to all AFIs for their comments; a number of managers tested a sample of their loan portfolio and submitted the results, comments and suggestions. The comments are contained in an attached file.
- A sample of 10 loans was randomly selected from 19 AFIs and a consultant that was an experienced business loans manager applied the loan risk-rating tool to them. The report is attached and was made available to all AFIs. A copy of the report is attached.

The sample revealed the following risk profile: (\$s)

Very low risk:	0%
Low risk:	14.3%
Medium risk:	41.4%
High risk:	43.1%
Very high risk:	1.2%